

SHORT-TERM MUNICIPAL SECURITIES

John R. Walter

Introduction

Short-term municipal securities are defined by two characteristics. First, they are issued by state and local governments and the special districts and statutory authorities they establish. Second, they either have original maturities of less than three years or have longer final maturities but include features which, from the investor's point of view, shorten their effective maturities to less than three years.¹ During 1985 approximately \$82 billion in short-term municipal securities were issued.

The interest income received by holders of municipal securities is generally exempt from federal income tax. The federal tax-free status of municipal debt was firmly established in the 1895 Supreme Court case *Pollock v. Farmers' Loan and Trust Company* and was reaffirmed by the first federal income tax law, passed in 1913 following the ratification of the Sixteenth Amendment. Since 1913, each new tax law has included a clause exempting interest income on most municipal securities from federal income taxes. As federal income tax rates increased, the importance of this exemption to investors and to municipal issuers grew. Because the interest income received by holders of most municipal securities is tax-exempt, the securities carry a lower rate of interest which in turn considerably lowers the borrowing costs of states and municipalities.^{2,3}

States and municipalities borrow to finance their own expenditures, to provide funds to be used by private firms and individuals (although changes to the Tax Code

in 1986 will significantly limit this borrowing), and to provide funds to some tax-exempt entities such as private nonprofit hospitals, colleges, and universities. Because municipal security issuers vary greatly in size and motivation for borrowing, the methods and instruments chosen to meet funding demands vary considerably. While a small city may sell a fixed-rate note directly to a local bank to finance the purchase of a snowplow until bonds are issued, a waste management agency may sell, through a municipal underwriter, numerous large denomination variable-rate securities to mutual funds and corporations to raise funds to build a solid waste disposal project.

Until 1980 almost all short-term tax-exempt securities had fixed interest rates and maturities of less than three years. Since then two new instruments have been developed and have grown rapidly: tax-exempt commercial paper and variable-rate demand obligations. These instruments have enabled state and municipal issuers to fund long-term projects at short-term rates. Issuers have had the incentive to raise funds at short-term rates because historically the yield curve in the tax-exempt market has been upward sloping.

In the past, state and local governments, school districts, public power and water authorities, and transportation authorities were the major issuers of short-term tax-exempt debt. In recent years agencies and authorities of municipal governments, such as housing, pollution control, and economic and industrial development authorities, have been growing in importance. Since the newer districts and authorities are more frequent users of the new instruments, the increase in the importance of these types of borrowers in the municipal market accounts for some of the growth in these instruments.

Characteristics of Short-Term Municipal Securities

Definition and Features Municipal securities are promises made by state and local governments and the districts and authorities they create to pay either one interest and principal payment on a particular date or a stream of interest payments up to maturity and a principal payment at maturity. They are backed by the issuer's ability to tax and borrow, by certain sources of funds, or by collateral. Municipal securities with original

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¹ Municipal market participants generally call securities short-term if they have maturities less than three years, or if they have features shortening their effective maturities to less than three years. Most major data-collecting firms, however, consider municipal securities short-term if they have maturities of no more than 12 or 13 months, or have features making their effective maturities no more than 12 or 13 months. As a result, the figures quoted throughout the article are based upon this criterion.

² Because tax law prohibitions or limitations have eliminated or restricted the ability of certain municipal issuers to issue tax-exempt debt, or may do so in the future, some municipal issuers have recently issued taxable securities.

³ In this article the term municipality refers to local governments and the special districts and authorities created by state and local governments. Some writers also use the term to refer to state governments.

maturities of greater than three years are generally called bonds, and those with maturities of three years or less are called short-term securities or notes.

Short-term municipal securities are issued in coupon or discount form. Coupon securities, the most prevalent by far, pay a stated tax-exempt interest rate, called the coupon rate, at maturity or on specified dates. This rate varies over the life of the issue in the case of variable-rate instruments. Discount securities are issued at a price less than their face value. The difference between the issue price and face value is tax-exempt interest income.

Short-term municipal securities are issued in either bearer or registered form. The 1982 tax law included a provision requiring all municipal securities issued after January 1, 1983 with maturities of greater than one year to be issued in registered form.

Short-term municipal securities are normally issued in denominations of \$5,000 or more. The denomination chosen depends upon the issuer's assessment of who the purchasers are likely to be. If the issuer is trying to sell to individuals, it will use a smaller denomination than if the issue is intended for institutional investors. Smaller denominations increase the average cost of marketing a new issue.

Short-term municipal securities can be either general obligation securities or revenue securities. General obligation securities are backed by the full faith and credit of the issuer, which uses its ability to tax and any other possible source of income to meet debt payments. The ability to tax may be limited by statute or constitution, in which case the general obligation security is called a limited tax security. Revenue securities are backed by revenues generated by the project the securities finance and not by the full faith and credit of the issuer. The revenues are usually future earnings on projects such as tolls from roads or rental income from a facility leased to a business. In some cases, however, the revenues can be funds from specific taxes, receipts from bond sales, or transfers from the federal government.

Most of the securities issued by special districts and statutory authorities are revenue securities backed by revenues from the projects the securities finance. Many districts and authorities cannot tax, so they do not have the ability to make a general obligation pledge. At times, however, the securities of such a district or authority are backed by a general obligation pledge from the state or local government that founded it. Table I lists the major issuers of municipal debt and the types of securities they normally issue.

Traditional Instruments Traditionally, short-term municipal securities have been issued to meet short-

TABLE I
ISSUERS OF SHORT-TERM MUNICIPAL SECURITIES
AND TYPES OF DEBT ISSUED

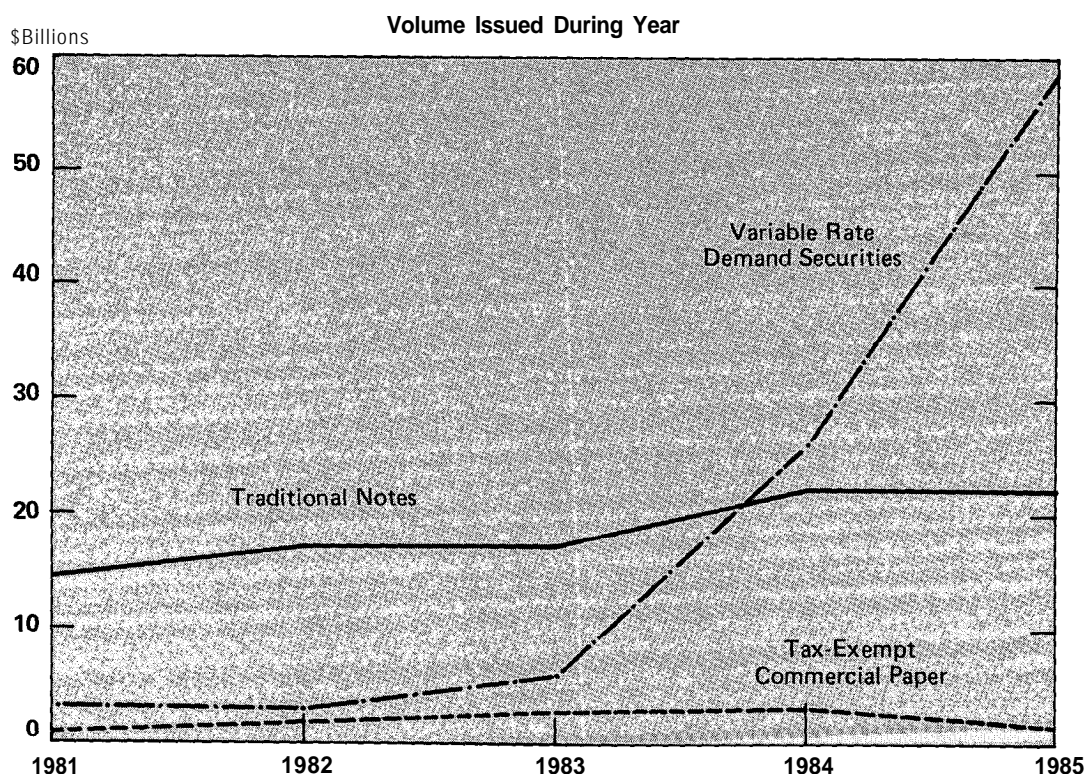
Issuer	Types of Debt Generally Issued
State government	G.O. and revenue
Local government:	G.O. and revenue
City	G.O. and revenue
County	G.O. and revenue
Authorities, districts, and agencies created by state and local governments:	
Public school	G.O. and revenue
Higher education	G.O. and revenue
Public power	Revenue
Water or sewer	Revenue
Transportation	Revenue
Health facilities	Revenue
Student loan	Revenue
Housing finance	Revenue
Pollution control	Revenue
Industrial development	Revenue
Waste management	Revenue

Note: G.O. denotes general obligation.

term demands for cash and have paid fixed interest rates. The popular traditional issues are revenue anticipation notes (commonly called RANs), tax anticipation notes (TANs), grant anticipation notes (GANs), tax and revenue anticipation notes (TRANs), and bond anticipation note (BANs). Each receives its name from its source of repayment. These issues have minimum denominations of \$5,000 and their maturities are fixed with repayment coming from funds available at or before the maturity date. Traditional notes remain significant in the short-term municipal market (Chart 1).

Funds from such sources as taxes, grants, and project revenues are often received as large payments a few times a year, while expenditures must be made continually. In order to make expenditures before funds are received, states and municipalities issue notes that are paid back by future receipts. Funds from future bond issues are used to repay bond anticipation notes. Here, states and municipalities construct projects to be financed with bonds but require immediate funds for payrolls and purchases. Rather than issuing bonds before a project is finished and the final costs are certain, states and municipalities may first sell notes that are retired with the proceeds of bonds issued upon completion of the project. For example, a county recently issued \$32 million of one-year fixed-rate bond anticipation notes to finance part of the construction of a waste water treatment facility. The notes were revenue securities, backed by funds to be received from future bond sales.

Chart 1

SHORT-TERM MUNICIPAL SECURITIES

Source: Securities Data Company, Inc.; Standard & Poor's

There are other uses for bond anticipation notes. For example, at certain times states and municipalities may expect to be able to sell long-term securities in the future at lower rates than are available currently, so they issue notes and retire them with future bond proceeds. Also, municipalities frequently finance several projects with one bond issue. Short-term notes can be issued to pay for the completion of the individual projects, after which the notes are retired with one long-term bond issue. Despite the various uses to which bond anticipation notes may be put, they have become fairly uncommon in recent years as frequent tax law changes have made issuers wary that changes in the law could eliminate their ability to issue bonds needed to repay these notes.

New Instruments Since 1980 two new instruments have become prominent: tax-exempt commercial paper and variable-rate demand or put obligations. A number of factors contributed to the development of these instruments. The volatile interest rates of the late 1970s and early 1980s lead to greater demand by investors for short-term and variable-rate investments. Issuers were also interested in relying more on short-

term debt to meet their demand for longer-term funds because the tax-exempt yield curve was strongly and persistently upward sloping. Issuers were unwilling, however, to use the traditional short-term instruments to raise long-term funds because of the high legal, administrative, and marketing costs of issuing and reissuing these securities for an extended period. Finally, the ability of issuers to sell the new instruments was greatly facilitated by the rapid growth of tax-exempt money market mutual funds which expanded the market for these instruments considerably by increasing the ability of investors to purchase them.

Tax-exempt commercial paper, which began to grow in late 1979, is short-term fixed-rate paper, normally issued with the intention of redeeming maturing paper with funds from newly issued paper. Almost all maturities are between 1 and 270 days and are determined by negotiation with investors. Tax-exempt commercial paper is used to fund both short- and long-term projects. When funding long-term projects, maturing paper is replaced with new issues at current market rates.

The tax-exempt commercial paper market is a highly sophisticated market requiring the issuer to maintain

daily contact with the market and good communication with its marketing agent. This is necessary because tax-exempt commercial paper issuers generally allow investors to choose from a span of maturities so that some paper is maturing almost every day and therefore must be replaced with new paper on a daily basis. The frequent involvement of issuers and their agents in the market imposes a significant cost on issuers. Because of this cost states and municipalities do not find it attractive to issue commercial paper unless they are borrowing \$15 to \$25 million or more.

Minimum denominations generally range from \$50,000 to \$100,000. Money market funds are the major investor in tax-exempt commercial paper. Some tax-exempt commercial paper also is purchased directly by corporations, bank trust departments, and wealthy individuals. While there is no developed secondary market in commercial paper because of its extreme short-term nature and its individualized maturities, dealers will as a rule buy back paper they have sold.

As an example of a commercial paper issue, one state has been using a tax-exempt commercial paper program for four or five years to finance its capital projects. The amount outstanding in the program varies with funding demands and is authorized by the state government to be as much as \$90 million. Denominations range between \$50,000 and \$5,000,000 with the securities typically sold in \$1,000,000 lots. Maturities are between 3 days and 210 days depending upon investors' desires. Most of the commercial paper has been purchased by money market funds. This program will be continued unless the state decides that bonds can provide lower cost funds.

Variable-rate demand obligations began to grow in 1981.⁴ They can be either general obligation or revenue securities, but the majority are revenue securities. Minimum denominations range from \$5,000 to \$100,000. Variable-rate demand obligations now come in many forms with almost as many variations as there are dealers in the tax-exempt money market. They share certain characteristics, however. First, while these instruments may have final maturities from short-term up to forty years, they all include features which allow for periodic interest rate adjustments. Second, they include a feature known as a demand option which gives the investor the right to tender the instrument to the issuer or a designated party on a specified number of days' notice at a price equal to the face amount (par value) plus accrued interest. The length of the notice

period normally corresponds with the frequency of interest rate adjustment. For example, if the interest rate is adjusted on a weekly basis, the variable-rate security will generally have a seven-day notice period. If in the investor's judgement the new rate is too low or if the investor wants his money back for some other reason, he exercises his demand option. In this case the instrument is resold to another investor. Third, many of these securities contain a provision allowing the issuer, after properly notifying all holders and allowing them the opportunity to tender their holdings, to convert the variable-rate security into a fixed-rate security with no demand feature. For example, a higher education authority issued \$9 million of variable-rate revenue bonds, in \$100,000 minimum denominations, to finance campus construction and renovation. These securities have a 25-year final maturity but include a weekly demand feature. Most of the securities are in the portfolios of tax-exempt money market funds.

Variable-rate demand obligations have one important advantage for states and municipalities over tax-exempt commercial paper. When commercial paper matures and is replaced with new commercial paper, the new security is legally defined as a new debt issue and is subject to regulations in place at the time of its issue. Since Congress has been imposing and shrinking limits on certain types of issues in recent years, issuers wishing to borrow for an extended period by using commercial paper face the danger of having a newly imposed or tightened limit eliminate their source of funds. In contrast, because new debt is not issued when an investor exercises his demand option, variable-rate demand obligation issuers are not faced with this danger. This advantage of variable-rate demand obligations over tax-exempt commercial paper may explain their rapid growth compared with commercial paper (Chart 1).

The length of the notice period on a variable-rate demand obligation determines its effective maturity from the investor's point of view and therefore strongly affects the interest rate which must be paid on the instrument. The most common notice periods are one day, seven days, and thirty days. As a result of a fairly consistently upward sloping yield curve in the municipal market, it is generally true that the shorter the notice period the lower the rate paid.⁵

Information on each of the commonly used 'short-term municipal instruments is provided in Table II.

⁴The terms "demand" and "put" are used interchangeably in the municipal security market. In this paper "demand" is used.

⁵For a more detailed discussion of tax-exempt commercial paper and variable-rate demand obligations see Smith Barney, Harris Upham and Company, Incorporated [1986, pp. 10-14].

TABLE II
INSTRUMENTS COMMONLY USED IN THE SHORT-TERM MUNICIPAL MARKET

Security Name	Types of Pledge	Features
TRADITIONAL NOTES		
Revenue Anticipation Note	G.O. or revenue	Fixed maturity of a few weeks to one year, fixed interest rates
Tax Anticipation Note	G.O. or revenue	Fixed maturity of a few weeks to one year, fixed interest rates
Grant Anticipation Note	G.O. or revenue	Fixed maturity of a few weeks to three years, fixed interest rates
Tax and Revenue Anticipation Note	G.O. or revenue	Fixed maturity of a few weeks to one year, fixed interest rates
Bond Anticipation Note	G.O. or revenue	Fixed maturity of a few weeks to three years, fixed interest rates
NEW SECURITIES		
Variable Rate Demand Obligation	G.O. or revenue; Liquidity facility, Credit facility	May be tendered to issuer or designated party on a specified number of days' notice, floating or variable interest rate. Many include features which allow conversion to a fixed rate long-term maturity.
Tax-Exempt Commercial Paper	G.O. or revenue; Liquidity facility, Credit facility	Maturities of a few days to one year depending on investor and issuer preference; interest rate fixed to maturity; continuously offered.

Note: G.O. denotes general obligation.

Dealers

Most large banks and securities firms, along with some firms specializing only in municipal securities trading, act as dealers in the short-term municipal market. Municipal securities dealers underwrite and market new security issues and provide a secondary market for outstanding securities. With a few exceptions, banks are limited by the Glass-Steagall Act of 1933 to underwriting only general obligation securities.

Underwriting is the purchase of securities from the issuer with the intention of reselling them to investors. Once the underwriter has purchased the securities it bears the risks of marketing them. Security issues may be underwritten by one dealer if the issue is small or by a group of dealers, called a syndicate, if the issue is larger than one dealer would like to handle. In a syndicate one dealer acts as the lead dealer in the group, taking the largest proportion of securities and managing the sale of the issue. Syndicates are used to spread the market risk among more dealers and to enlarge the number of possible investors. As compensation the underwriter receives the spread between the price paid the issuer for the securities and the price received from investors. The risk faced by the under-

writer is that the security issue will not sell at a price that will earn a profit. A major source of this risk occurs when interest rates unexpectedly rise before the underwriter has sold the issue to the public.

Municipalities that choose a public offering must decide whether to sell their securities by competitive bidding or by a negotiated sale. In competitive bidding the issue is advertised for sale and then sold to the underwriting dealer or syndicate of dealers offering the highest price. In a negotiated sale an issuer chooses one dealer or syndicate without soliciting bids from other firms. Variable-rate municipal securities are most frequently sold through negotiated deals, while tax-exempt commercial paper is always sold in this manner.

In a traditional note issue the dealer's responsibility to the issuer is limited to the initial sale of the securities. For variable-rate and commercial paper issues the lead dealer's responsibility is more extensive. When variable-rate obligations are used, the lead dealer generally becomes the remarketing agent and has the responsibility of resetting the interest rate on interest rate adjustment dates and reselling any securities which are tendered by investors. When commercial paper is issued, the dealer is involved in the daily

setting of rates and in selling new paper to replace maturing paper.

Dealers generally will make a secondary market in the short-term securities they have sold, which means they will stand ready to buy and sell these securities at any time. Dealers are kept informed of securities being offered and rates being paid through several electronic services and daily publications. Due to the heterogeneous nature of municipal issues, the secondary market in municipal securities is not nearly as developed as that for corporate and government debt issues.

Brokers in the municipal market line up dealers selling particular issues with dealers who are interested in buying these issues. Brokers deal only with large volumes and charge a small fee for their middleman services.

Providers of Credit and Liquidity Enhancements

In order to improve the credit ratings and marketability of their securities, municipal issuers frequently get credit or liquidity enhancing agreements. Under these agreements banks, corporations, and insurance companies promise, for a fee, to provide funds if an issuer is unable or unwilling to make payment to the holders of the issuer's debt. Such an agreement substitutes the credit or liquidity of the bank, corporation, or insurance company for that of the municipal security issuer.

These agreements fall into one of two categories. The first is the credit substitution agreement. This is simply a contract made with the municipal security issuer to make payment if the issuer does not. Under this contract the security holder has a claim against the promising party if the issuer defaults. The second category is the liquidity substitution agreement. This is a promise, generally made by a bank, to provide a loan to the municipal issuer or its agent to redeem maturing or tendered securities, or to itself purchase such securities outright. The liquidity agreement is activated when the remarketing agent cannot resell the maturing or tendered securities at an interest rate below some maximum set by the issuer or when it cannot resell them at all.

Banks are the most common providers of credit substitution agreements in the short-term municipal market. Banks provide the agreement, for a fee, by means of an irrevocable letter of credit. Insurance companies provide the same type of promise through municipal bond insurance. Also, a corporation that benefits from a project often guarantees payment of principal and interest for the related securities. Since only municipal issues with top ratings are purchased by the money market mutual funds, issuers wishing to sell

less than top rated securities to these funds must obtain a credit substitution promise.

Most liquidity substitution agreements are provided by large U.S. and foreign banks. The agreements come in the form of either a bank line, a standby letter of credit, or a standby purchase agreement. The liquidity substitution promise provides the investor with the assurance that funds will be immediately available when he redeems his security.

The traditional short-term municipal securities typically do not require liquidity promises, while variable-rate demand obligations and commercial paper issues almost always require such promises. Variable-rate obligations require liquidity substitution backing because of the danger that the security holders will exercise their demand option at a time and in sufficient numbers that the remarketing agent will not be able to resell the securities and the issuer will not have sufficient funds to redeem them. Institutional investors, the biggest purchasers of such securities, require that this risk be covered. Similarly, there is some danger that when existing paper matures the commercial paper issuer's marketing agent will be unable to sell new paper and that the issuer will not have sufficient funds to redeem them. Issuers of commercial paper must back their issues with liquidity facilities to assure investors that funds will be immediately available at maturity.

Investors

An investor's decision whether to purchase a taxable or tax-exempt security depends largely on his marginal tax rate and the rates being paid on tax-exempts and taxables. The after-tax return on a taxable security is $r(1-t)$ where r is the before-tax rate of return on the taxable security and t is the investor's marginal tax rate. Yields on tax-exempt securities are frequently stated in taxable equivalent terms, or in terms of what taxable interest rate would be necessary to provide the same after-tax interest rate. The taxable equivalent formula is

$$r_T = r_{TF}/1-t,$$

where r_{TF} is the rate paid on the tax-free instrument and r_T is the equivalent yield of a taxable instrument for investors with a marginal tax rate of t . For example, if an investor in the 33 percent marginal federal tax bracket purchases a tax-exempt security paying 6.7 percent, then a taxable security paying 10 percent would yield this investor the same after-tax rate as the tax exempt security. If the investor's taxable equivalent yield on municipal securities is greater than the yields he can earn on taxable securities of comparable risk he will profit by investing in tax-exempt securities.

The value of the tax exemption to the investor is increased when the income earned also is exempt from state income tax. This is true for investors purchasing securities issued by their home state or by municipalities located in their home state. In this case the security is "double tax-exempt" for the investor and the relevant taxable equivalent formula is

$$r_T = r_{TF} / [1 - (t_F + t_S(1 - t_F))],$$

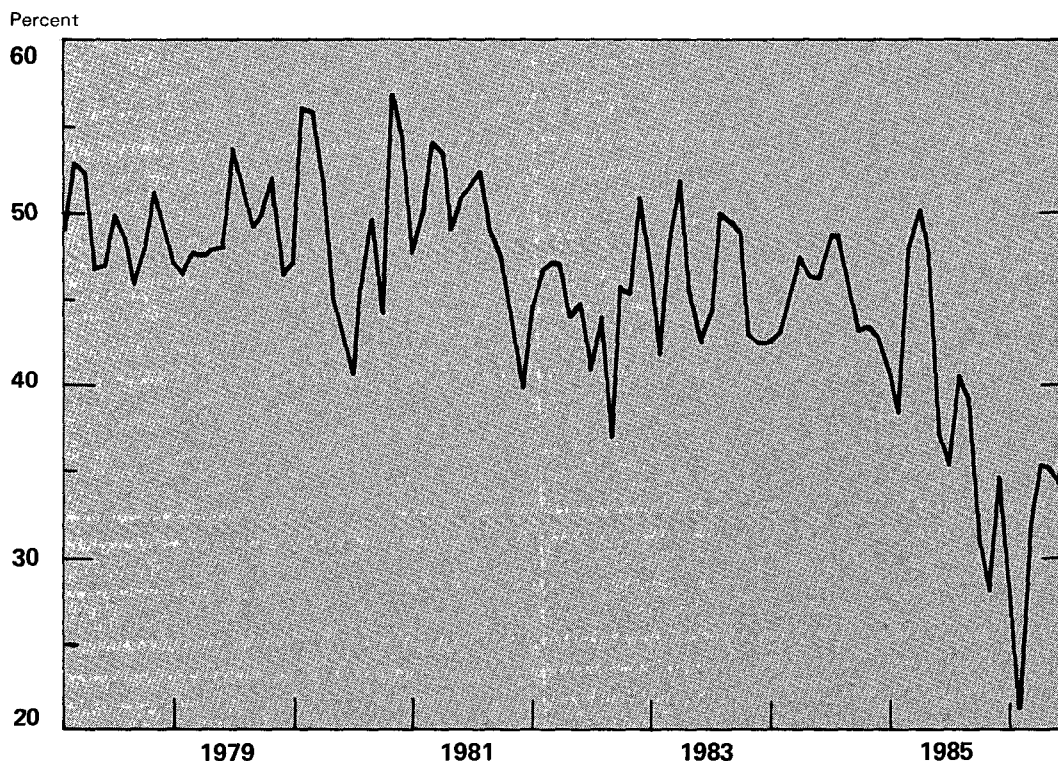
where t_F is the marginal federal tax rate of the investor and t_S is the marginal state tax rate of the investor. This formula takes into account that state income taxes are deductible on the federal return. Suppose the above investor in the 33 percent federal tax bracket has a 10 percent state income tax rate. The total tax rate faced by the individual is $.33 + .10(1 - .33) = .40$. If the municipal security being considered is exempt from state income taxes and is paying a 6.7 percent rate of return then the taxable equivalent yield for this investor is 11.1 percent.

Chart 2 graphs the implicit marginal tax rate that equated the after-tax yields on six-month maturity Treasury securities and six-month maturity prime tax-exempt notes from 1978 through mid-1986. This tax rate averaged 49.4 percent from January 1978 through September 1981, fell to an average 45.4 percent from October 1981 through April 1985, and then fell further to an average 33.6 percent from May 1985 through June 1986. The reasons for the decline in the period after September 1981 are not entirely clear. The 1985 decline probably resulted from the massive issue of new short-term debt brought on by municipal issuers' fears of tax law changes taking affect after the end of 1985.

Individuals Most individuals investing in short-term municipal securities do so through tax-exempt money market funds, which held approximately 50 percent of all short-term municipal debt at the end of 1985 (Chart 3). Tax-exempt money funds allow smaller investors to diversify their portfolios of municipal secu-

Chart 2

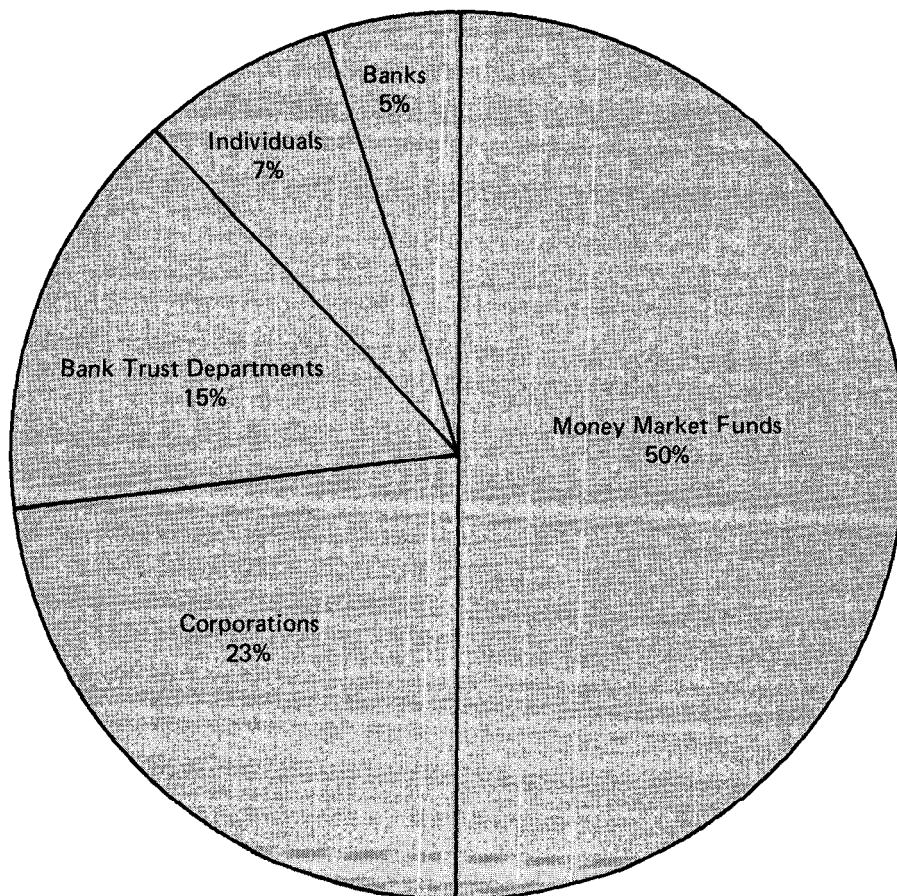
TAX RATE EQUATING AFTER-TAX YIELDS ON TREASURY BILLS AND PRIME TAX-EXEMPT HOUSING NOTES (Six-Month Maturities)



Source: Yield series are from Salomon Brothers, *An Analytical Record of Yields and Yield Spreads*.

Chart 3

HOLDINGS OF SHORT-TERM TAX-EXEMPT SECURITIES



Source: Smith Barney, Harris Upham & Co. Incorporated, Public Finance Division.

rities, which would not otherwise be possible for most of these investors because minimum denominations of short-term tax-exempts start at \$5,000. Some individuals do invest in short-term securities directly, either through a securities dealer or through a bank with a dealer department. Chart 3 shows that approximately 7 percent of outstanding short-term municipal debt was held by individuals investing directly.

Individuals can invest in short-term tax-exempt securities through a bank trust department. Bank trust departments held 15 percent of short-term municipal debt outstanding at the end of 1985. Bank trust departments also often invest their customers' funds in tax-exempt money funds, which show up in Chart 3 as investment by money funds.

Corporations At the end of 1985, corporations directly held about 23 percent of the outstanding short-

term municipal securities. In addition they indirectly held some short-term municipal securities through money market funds. Corporations invest in these securities because their corporate federal and state tax rates together generally have been high enough to make tax-exempts profitable. Corporations invest in short-term municipal debt mostly as a repository for their short-term operating reserves or seasonal reserves.

Commercial Banks At the end of 1985 banks held about 5 percent of all short-term municipal debt. Banks' holdings of municipal debt as a percentage of their total assets declined from 1980 through 1984. This decline can be explained by two factors. First, aggregate bank profits consistently fell over those years, which diminished banks' incentive to protect income from taxes. Second, the Tax Equity and Fiscal Responsibility Act

(TEFRA) of 1982, eliminated part of the interest deduction of municipal security carrying costs, and therefore lowered the effective return banks could earn on tax-exempts beginning in 1983.⁶ In 1985, however, banks' holdings of municipal securities as a percent of total assets grew to slightly more than it was in 1980. This growth was the result of banks' concern over the possibility of enactment of legislation in 1986 making municipal securities purchased after 1985 less attractive and because of somewhat higher income in 1985.

As it turned out, banks' concern about the 1986 tax law was well-founded. The new tax law will in most cases eliminate banks' ability to deduct the interest expense of funds used to carry municipal securities purchased after August 7, 1986. Before the change, banks were allowed to deduct from their taxable income an amount equal to 80 percent of the interest expense of funds used to carry municipal securities. The elimination of this tax deduction has already caused banks to reduce their investments in municipal securities and will significantly diminish their importance as purchasers of municipal securities.

Banks will be allowed to continue to deduct 80 percent of the interest expense for funds used to purchase municipal securities financing traditional governmental projects or hospital and university projects if the issuer expects to issue less than \$10 million in debt per year. This will enable these small issuers to continue to sell securities to some banks, but will largely eliminate banks as purchasers of other issuers' securities.

Regulatory and Legislative Effects

Regulation has only a limited direct effect on the municipal securities market. Issuers' debt offerings are not regulated except by general financial regulations. For instance, conditions under which tax-exempt commercial paper can be issued are set by the Securities and Exchange Commission (SEC). The Municipal Securities Rulemaking Board (MSRB) was established in 1975 to develop and update regulations by which dealers, dealer banks, and brokers in the municipal market are to operate. These regulations are enforced by the SEC, the federal bank regulators, and the National Association of Securities Dealers.

The regulation of money funds by the SEC indirectly affects the short-term municipal market significantly since municipal money funds are such important purchasers in the market. SEC regulations governing money market funds' purchases and holdings have been

important in promoting certain types of short-term municipal securities. (See the chapter on money market funds.)

Federal tax legislation can result in significant changes in the municipal market. In particular, the repeal or proposed repeal of the tax-exempt status of certain types of issues can drive the market to extreme reactions. Such a reaction was seen at the end of 1985 when Congress' proposed restrictions on tax-exempt borrowing produced a record volume of municipal issues. The Tax Reform Act of 1986 should have a number of effects on the municipal market. Banks should become less active investors in municipals because of the loss, in most cases, of their interest cost deduction. The ratio of tax-exempt to taxable yields may rise because the act lowers marginal tax rates for many individuals and corporations. And many private use issuers will lose their ability to issue tax-exempt debt, while others will have caps imposed on the amount of tax-exempt debt they are allowed to issue.

State legislation can also cause changes in the municipal market by limiting the amount or type of tax-exempt debt that may be issued. For example, following California's Proposition 13 the volume of general obligation debt issued by California municipalities fell significantly.

Conclusion

Short-term municipal securities have become important instruments of the money market. Traditional notes such as revenue anticipation notes, tax anticipation notes and bond anticipation notes, remain important to issuers wishing to borrow funds for short-term purposes, but these notes have been responsible for only a small portion of the recent growth of the short-term municipal market. Most of the growth in this market has resulted from states' and municipalities' use of variable-rate securities and tax-exempt commercial paper. The newer instruments have augmented the traditional short-term notes to provide the investor with securities having little interest rate risk, while enabling issuers to gather funds for long-term projects at short-term rates.

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⁶Proctor and Donahoo [1983-84, pp. 31-32].

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